

DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 00-0209
State Gross Retail Tax – Manufacturing Exemption
For Tax Years 1996 through 1998

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ISSUES

I. State Gross Retail Tax—Manufacturing Exemption

Authority: *Chrome Deposit Corp. v. Indiana Dept. of State Revenue*, 557 N.E.2d 1110 (Ind.Tax 1990); aff'd, 578 N.E.2d 643 (Ind. 1991)
IC 6-2.5-2-1; IC 6-2.5-5-3(b)
45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(g); 45 IAC 2.2-5-12(a)

Taxpayer protests assessments of Indiana sales tax on its use of polypropylene resin, maintaining that this item qualifies for the manufacturing exemption.

II. Tax Administration—Records

Authority: IC 6-8.1-5-1(a)

Taxpayer disputes the dollar figure used by the Indiana Department of Revenue's auditor to determine the use tax assessed against the polypropylene resin.

III. Tax Administration—Abatement of Penalty

Authority: IC 6-8.1-10-2.1(d); IC 6-8.1-10-4
45 IAC 15-11-2; 45 IAC 15-11-2(b); 45 IAC 15-11-2(c)

Taxpayer protests imposition of a ten percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer, an out-of-state corporation with a plant location in Indiana, produces high performance thermoplastic resins. Taxpayer refines the effects of base resins through

electrical and thermal activity, lubricity, structural strength, dimensional stability, and color accuracy. Taxpayer's customers in turn use the resins as raw material in the manufacturing of plastic parts.

The Department of Revenue conducted an audit for the years in question, and issued assessments on the low-grade polypropylene resin used to purge production equipment between production runs. Taxpayer maintains that the use of the low-grade resin is a material part of the production process.

I. State Gross Retail Tax—Manufacturing Exemption

DISCUSSION

Taxpayer protests the auditor's determination that the low-grade resin used to purge production equipment between production runs does not qualify for the manufacturing exemption available under 45 IAC 2.2-5-14 because the low-grade resin is not used in the production process and does not constitute a material or integral part of taxpayer's finished product. Taxpayer maintains that its use of the low-grade resin is a material part of the manufacturing process and is, therefore, exempt from the state gross retail tax.

Pursuant to IC 6-2.5-2-1, a sales tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana unless a valid exemption is applicable. Under IC 6-2.5-5-3(b), 45 IAC 2.2-5-12(a), an exemption from the state gross retail tax is provided for transactions involving manufacturing machinery, tools, and equipment if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. (Emphasis added). 45 IAC 2.2-5-8(c) defines "direct use" as use having an immediate effect on the article being produced. Property has such an immediate effect if it is an essential and integral part of an integrated process that produces tangible personal property. 45 IAC 2.2-5-8(g).

In *Chrome Deposit Corp. v. Indiana Dept. of State Revenue*, 557 N.E.2d 1110 (Ind. Tax 1990); *aff'd*, 578 N.E.2d 643 (Ind. 1991), the court found that cleaning supplies were exempt from Indiana sales and use tax pursuant to IC 6-2.5-5-3 when they were found to be an essential and integral part of the production process. *Id.* at 1118. In that case, the taxpayer manufactured layered hard chromium metal (a chromium sleeve) that was applied to customers' work rolls. Prior to application, the work rolls were "placed into a 'scrub tank' and physically scrubbed with sponges, water, and a special cleaning material that removed surface impurities." *Id.* The court held that "[t]hese cleansing items [were] an essential and integral part of the integrated process by which the hard chromium metal is produced and applied to the work rolls." *Id.* For these reasons, the court found that Chrome Deposit could take advantage of the industrial exemptions for its cleaning supplies. *Id.*

The court in *Chrome Deposit* did not find cleaning supplies exempt because they were used in cleaning activities, as there is nothing intrinsic in cleaning to transform supplies used - supplies normally taxable - into exempt items. Rather, the court found that because these particular cleaning activities were essential and integral to Chrome Deposit's integrated manufacturing process, the items used and consumed qualified for the industrial exemptions.

In the instant case, taxpayer presented evidence that continuous production runs subject high-grade resins to electrical and thermal activity to produce special plastic pellets. Taxpayer maintains that its use of the low-grade polypropylene resin to purge production equipment between production runs is a material part of the overall manufacturing process. However, the Department agrees with Audit's conclusion that the purge performed between production runs constitutes a cleaning activity that is separate from the manufacturing process. The low-grade resin is used to clean the production equipment so that the materials from any prior production runs do not contaminate the following production run. After being run through the production equipment, the resin is discarded. The amount of low-grade resin used to purge the production equipment is independent of the size of the production run. When cleaning activities are performed between jobs, such use represents post-production maintenance activities. As such, the low-grade resin used and consumed in those activities does not qualify for the manufacturing exemption.

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Taxpayer's protest is denied.

II. Tax Administration—Records

DISCUSSION

Taxpayer further maintains that the dollar figure that the Department's auditor used to determine the use tax assessed on the low-grade resin is incorrect. According to taxpayer, the low-grade resin is used functionally in two ways: (1) as an essential and integral part of the manufacturing process; and (2) as a cleaning agent to purge the production equipment between production runs. Taxpayer opines that the dollar figure used by the Department's auditor incorporates low-grade resin used in the manufacturing process when it should have included only that low-grade resin which was used to purge the production equipment between production runs.

IC 6-8.1-5-1 provides in pertinent part that:

If the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the

amount of the unpaid tax on the basis of the best information available to the department. . . . The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made.

At the time of the audit, no information was available to the Department's auditor to reflect the amount of resin used to purge the production equipment. As such, the auditor used the best information available to determine the cost of the purge resin. At the hearing, taxpayer pointed to the evidence that it submitted with its protest letter, including invoices for the low-grade resin used to purge the production equipment (which invoices carry a specific company code denoting purge resin); and invoices for resins used in the manufacturing process (which invoices carry a different company code denoting resin used in the manufacturing process). Taxpayer's documentation shows that as part of taxpayer's regular course of business, taxpayer makes a distinction between purge resin and resin used in the manufacturing process.

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The taxpayer's protest is partially sustained on this issue to the extent that the low-grade resin is used in the manufacturing process. The auditor used the best information available at the time of the audit to determine the use tax assessment. However, in light of the evidence presented by taxpayer at hearing, the audit division is requested to review its findings and taxpayer's supplemental information to determine a more accurate percentage upon which to base its use tax assessment.

III. Tax Administration— Abatement of Penalty

DISCUSSION

Taxpayer protests the imposition of a ten percent (10%) negligence penalty.

IC 6-8.1-10-2.1(d) states that if a person subject to the negligence penalty imposed under said section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty. 45 IAC 15-11-2 defines negligence as the failure to use reasonable care, caution or diligence as would be expected of an ordinary reasonable taxpayer. Negligence results from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or Department regulations.

In order to waive the negligence penalty, taxpayer must prove that its failure to pay the full amount of tax due was due to reasonable cause. 45 IAC 15-11-2. Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed" 45 IAC 15-11-2(c). In determining whether reasonable cause existed, the Department may consider the nature of the tax involved, previous judicial precedents, previous department instructions, and previous audits. *Id.*

Here, the taxpayer maintains that its failure to remit sales tax was due to purchasing personnel's lack of knowledge as to which items in a manufacturing environment are subject to the Indiana sales tax; that taxpayer now understands what constitutes exempt status; and, that taxpayer will be hereafter in compliance for all future purchases. The Department determined that imposition of the negligence penalty was appropriate because taxpayer made no attempts to understand regulations governing taxable purchases in a manufacturing environment; issued exemption certificates for numerous purchases that were determined upon audit to be taxable; and submitted annual sales/use tax filings showing no tax due.

Although taxpayer is an out-of-state corporation and is subject to its first audit by the Department, taxpayer has, nevertheless, failed to demonstrate that, in those areas of concern raised by the Department, it exercised the degree of reasonable care required to justify waiving the ten percent negligence penalty. Waiver of the penalty is inappropriate.

FINDING

Taxpayer's protest is respectfully denied.